WHITE PAPER

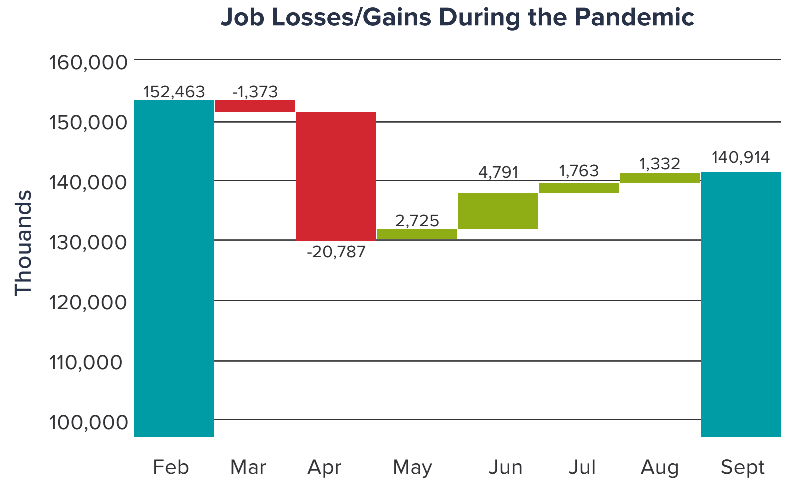
2021 Auto Lending Outlook

Introduction

This has been a year of unprecedented changes—a global pandemic, country-wide lockdown, massive loss of employment, economic downturn, and an uncertain future outlook have combined to create unique challenges for individuals and lenders alike. What impact has the COVID-19 pandemic had on automotive lending? In this white paper, our industry experts weigh in on the most significant factors affecting the auto lending industry in 2020, provide insightful analysis and a forward-looking perspective for 2021.

Labor Market Disruptions

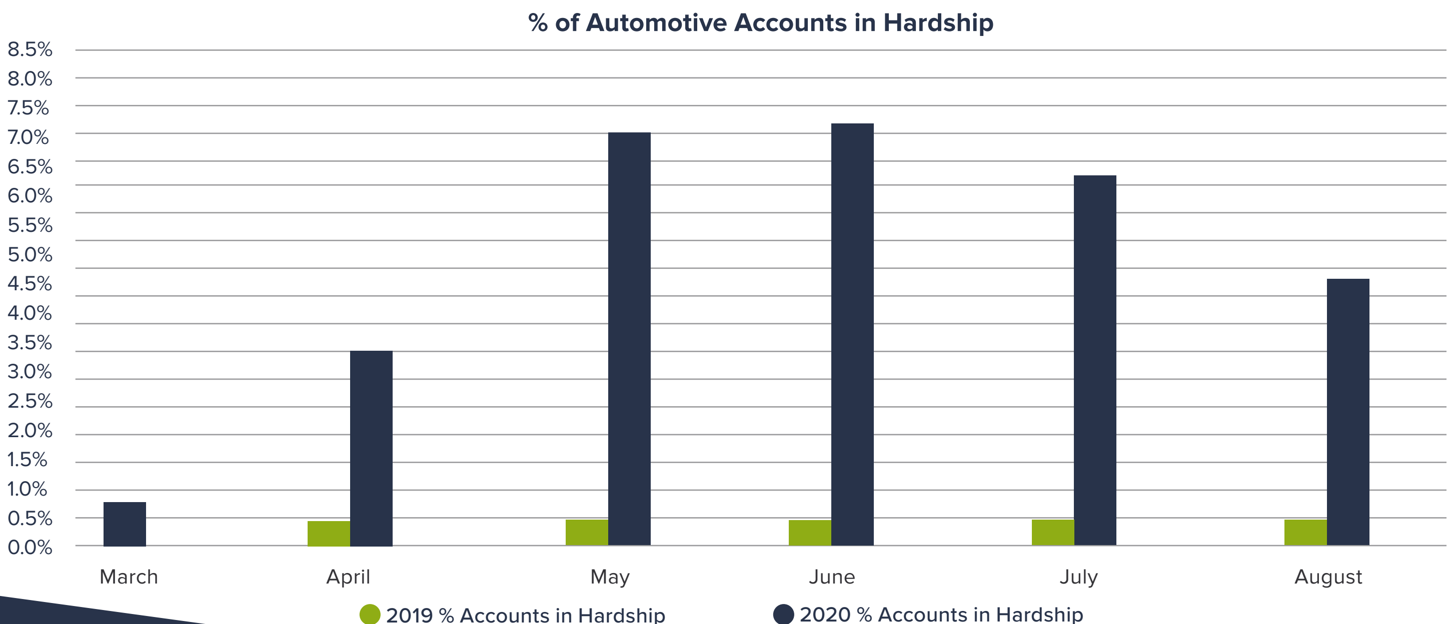
The coronavirus and subsequent social distancing measures put in place to help slow the spread of the disease caused major disruptions across nearly all industries in 2020. Although we have somewhat recovered from the initial shock of job losses in the spring, mass furloughs and layoffs have negatively affected millions of Americans—between February and August 2020, our nation lost nearly 11.6 million jobs. With government stimulus funds drying up and gridlock in Congress on further relief spending, this has created very real economic hardship for many families, which in turn is driving up delinquency rates.



Source: https://www.blackbook.com/covid-19-market-insights-9-29-20/

Rising Economic Hardship

Accounts in hardship are those that have been affected by a natural or declared disaster; reported as in forbearance; reported as deferred; or reported as having a frozen account status and/or past due notice. According to industry analysts, "The number of automotive accounts in hardship jumped substantially in April and kept increasing through June across all credit risk tiers. The numbers stabilized in July and currently, about 4.3% of all accounts are in hardship, which is almost a 1,400% increase over last year. As deferrals expire in the upcoming month, coupled with a high unemployment rate, lenders expect a large portion of these hardships to become delinquencies."[1]



Delinquencies Poised to Increase Dramatically

About 1.9 million vehicles were repossessed in 2019. In the early stages of the pandemic, most states enacted moratoriums on repossessions and most lenders offered deferral programs to help borrowers through the first several months. Those deferral programs have expired in most areas of the country. Per Black Book, “Our survey of lenders and automotive recovery companies suggest that the volume of repossessed vehicles will at least double in the next six months. We expect that there will be substantial challenges at every step of the process as recovery, transportation, and disposal are not fully recovered.”[1]

Increasing Loan Loss Provisions for Credit Unions

As evidence of this anticipation of higher delinquencies, there has been a large shift in the increase of Loan Loss Provisions by financial institutions. In particular, in Q2 2020, credit unions increased their contributions to Loss Provisions by 33.8% YOY, driving their Loan Loss Coverage Ratio—an indicator of how protected financial institutions are against future losses—to an all-time high of 172.2%.[2]

Credit Union Overview and Key Performance Indicator (KPI) Trends as of June 30, 2020

Source: CU Data

Tightening Credit Standards

While lenders are preparing for higher delinquencies, they are also tightening credit standards on new loans. Average credit scores have risen as loan amounts have increased, resulting in higher payments even while loan terms continue to extend. The average score for new financing on leases rose from 724 in Q2 2019 to 729 in Q2 2020. Credit scores on new loans rose five points year-over-year, up from 713 to 718. The average increase of credit scores across all new financing increased from 717 to 721.

On the other side of the risk spectrum, new auto loans to subprime lenders are at an eight-year low at 8.01%. The last time this happened was in 2011, when the number was 8.02%. New subprime loan originations were at 10.28% in Q2 2019, reflecting a 2.27% decrease year-over-year. Deep subprime loan originations are also at the lowest they’ve been in eight years, sitting at just 0.37% in September.[3]

In other words, more loans are being made to prime borrowers. Credit scores are rising for new financing. Therefore, with more loans being made to prime borrowers, the credit risk to lenders should be less. Of course, the margins are lower and lenders will make less money on prime borrowers as opposed to subprime borrowers, but it’s the right strategy for these uncertain times.

Decreasing Consumer Demand Drives Down New Vehicle Sales

Overall, new vehicle sales were down 21.5% during the first eight months of 2020 compared to the same time period last year (with a 19% YOY decline in July).[4] Automotive experts project a 22% drop in new vehicle sales in 2020 due to continued reduction in consumer demand. According to industry experts, “This is the result of several ongoing factors, including less miles driven due to remote work and shelter-in-place initiatives, high unemployment, and an overall feeling of uncertainty by consumers.”[1]

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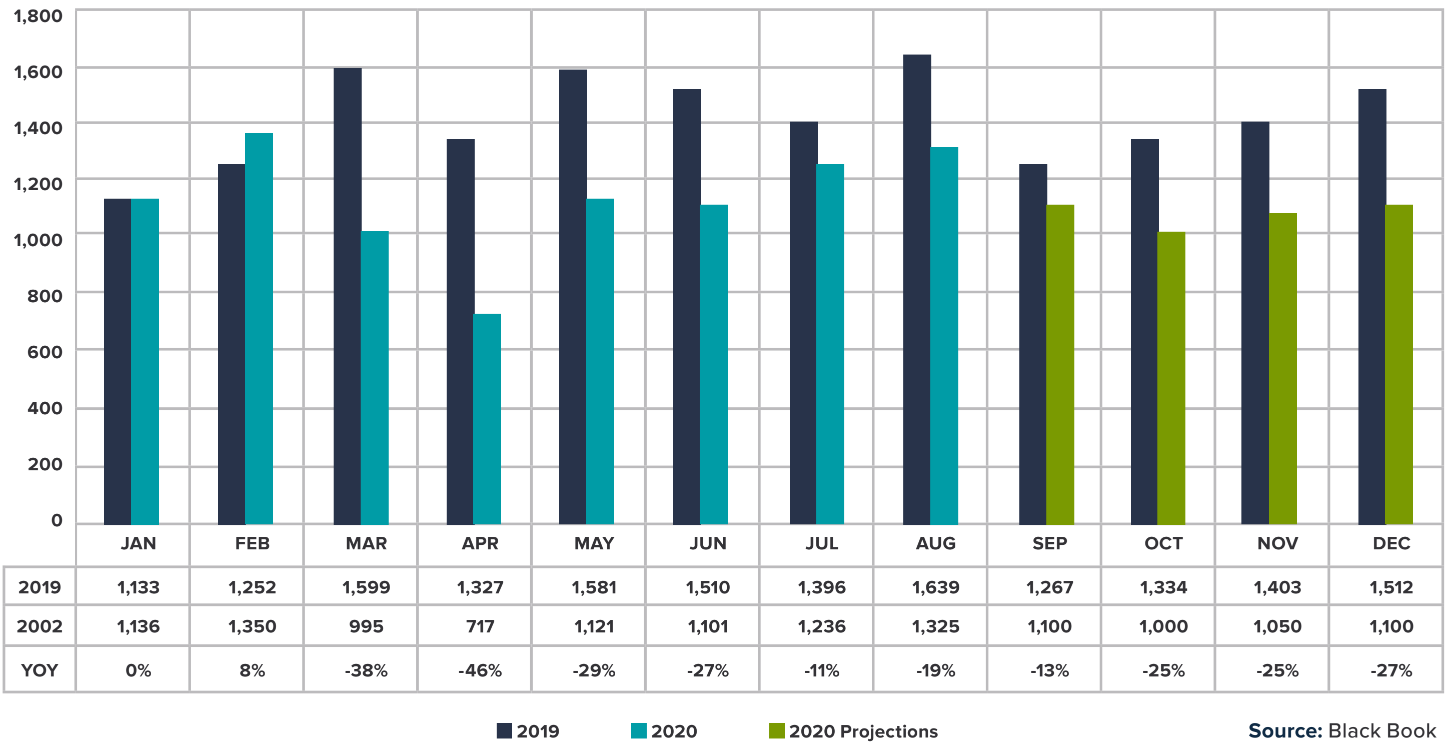
The graph below shows Black Book's actual new light weight vehicle sales through August and current projections for new vehicles sales for the remainder of 2020.



	JAN	FEB	MAR	APR	MAY	JUN	JUL	AUG	SEP	OCT	NOV	DEC
2019	1,133	1,252	1,599	1,327	1,581	1,510	1,396	1,639	1,267	1,334	1,403	1,512
2002	1,136	1,350	995	717	1,121	1,101	1,236	1,325	1,100	1,000	1,050	1,100
YOY	0%	8%	-38%	-46%	-29%	-27%	-11%	-19%	-13%	-25%	-25%	-27%

In the short term, the road to recovery will be marked with varying levels of unemployment and repossessions, but it appears most financial institutions are prepared to weather the storm. Although, if a second round of stimulus payments is not approved by Congress soon, it may further delay the recovery. In the longer term, industry analysts at Black Book expect new sales volume to return to pre-COVID levels within five years.

Factors Negatively Affecting Return-on-Assets

There are two major factors negatively impacting the Return-on-Assets (ROA) for credit unions and most financial institutions in 2020: shrinking Net Interest Margins and a dramatic increase in Provision for Loan Losses.

Net Interest Margin

As the Federal Reserve has indicated on numerous occasions, interest rates are going to remain low—near zero—for at least the next 12-15 months, and likely through 2023.[5] Therefore, Net Interest Margins are being squeezed. Rates should begin to recover toward the end of 2021 as consumer confidence improves, and if cost of funds remain low, the margins should improve for financial institutions. Financial institutions should do well in a rising rate environment as long as their cost of funds remain low and stable.

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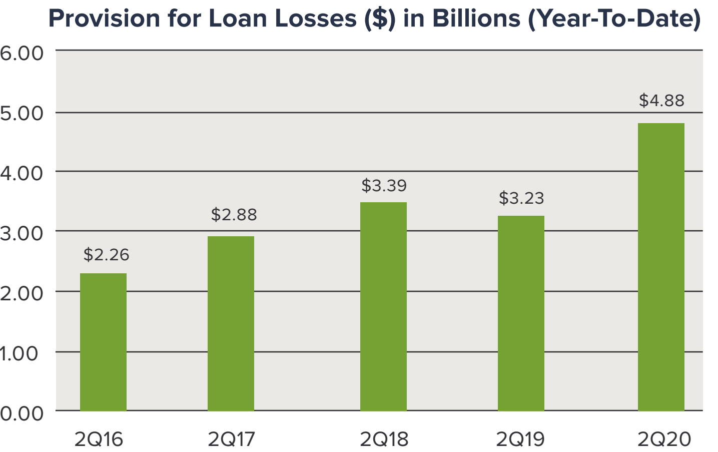
Increasing Provisions for Credit Unions' Loan Losses

The second major factor impacting the YOY reduction in ROA is the massive amount of funds credit unions are moving into their Provision for Loan Losses, in anticipation of higher defaults and charge-offs. These are pre-tax dollars that are being allocated to future Loan Losses which reduce their reportable income, thus reducing their ROA. This is a temporary situation which should rectify itself as delinquencies return to normal.



Source: https://cudata.com/pdfs/2Q2020.pdf

Conclusion

As auto lenders enter into what is normally the busiest time of the year, they will be challenged with increased competition from captive finance companies, lower demand for new cars, tightening interest rate margins, and lagging consumer confidence. The good news is, most financial institutions are well positioned to weather the anticipated storm of higher delinquencies and charge-offs in the short-term.

As we look toward 2021, the next round of financial stimulus relief should be approved by Congress and distributed to millions of Americans by early 2021—if not sooner. This will provide a boost to the economy and hopefully shore up consumer confidence. The national unemployment rate will continue to decline, but will not reach pre-COVID levels for several years.

As the economy continues to optimistically open up and Americans achieve a resemblance of normalcy, auto sales should be bolstered by low interest rates and stable gas prices. Finally, as drug companies continue their efforts to develop a suitable vaccine for the COVID-19 virus, consumers will become less fearful and more confident that a full recovery from this year of major disruptions is possible.

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Sources:

1 https://www.blackbook.com/covid-19-market-insights-9-29-20/

2 https://cudata.com/pdfs/2Q2020.pdf

3 https://www.experian.com/content/dam/marketing/na/automotive/quarterly-webinars/credit-trends/2020-q2-safm-final.pdf

4 https://fred.stlouisfed.org/series/LTOTALNSA

5 https://www.wsj.com/articles/fed-signals-interest-rates-to-stay-near-zero-through-2023-11600279214

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